On behalf of the officials and staff of our credit union, I would like to respond to your request for comments on the proposed rulemaking on corporate credit unions.

However, before addressing the particular issues on which you asked for comments, I would like to make several other comments of a general nature.

First, my opinion is that the manner in which the NCUA handled the $1 billion capital injection into U.S. Central was reprehensible. The NCUA is a regulator, but it is also the caretaker of the funds we have deposited into the NCUSIF. To make this capital injection without any prior notice and then inform us that we will have to replace these funds (and probably a lot more) is no way to run an organization. What difference would it have made if you had announced the need for this $1 billion capital injection and then given us a few days to digest all this? To my knowledge, U.S. Central did not have a cash flow problem necessitating the immediate capital injection. So why was this handled in such a manner?

Second, the NCUA bears a good portion of the responsibility for what has happened with U.S. Central and other corporate credit unions. It is my understanding that there are NCUA personnel in house at a number of the corporates. What were these people doing to protect the integrity of the corporate system and the NCUSIF?

My time in management of a federal credit union goes back to 1973. Over these years, there have been numerous field examiners and supervisory examiners in our credit union. A common observation I have made with most of these people is that they are always addressing last year's problem. This strikes me as the equivalent to trying to drive a car looking through the rear view mirror.

A regulator certainly needs to address the problems as they occur – but they also need the wisdom and foresight to look ahead and try to foresee what problems may lie down the road. Trends should be noted, and the possible ramifications of these trends should be studied by well qualified professionals (and by well qualified professionals, I am not talking about some 24 year old fresh out of college with an MBA). Deducing dangerous trends and addressing them before they become serious problems is far better than frantic damage control after the problems occur.

Here are a couple of examples to help explain my thinking on this issue.

I personally believe that credit unions are getting too heavily into long term real estate lending. This form of lending is fine – if the credit union sells the loan to a financial entity that has the deposit and capital structure to handle long term loans. By so doing, the credit union is providing an excellent service to its membership. However, for a credit union to make long term real estate loans and hold the loans on its books is playing with fire. Our deposits are primarily short term. Our share accounts are really overnight deposits, and most credit union CD's are done for five years or less. Getting into long term real estate lending may be good PR because we are meeting another need of our members; however, we need to recall what happened in the 1970's and 1980's to the

S&L industry when they found themselves holding long term assets and short term deposits. The U.S. taxpayers are still paying for this fiasco.

For a number of years, I served on the Board of Directors of our state's corporate credit union. We were examined during this time by many different NCUA examiners. The guiding principle from these examiners always seemed to involve addressing interest rate risk. This is understandable given what had happened with the S & L industry. However, interest rate risk is not the only risk involved in corporate credit union investments. Systemic risk is also present, and I never detected any real concern for this from your various examiners.

When our corporate first got into asset backed securities, one thing that immediately caught my attention was what I saw as the small spread between the return on these securities and the return on agency-backed securities and treasuries. The risk involving asset backs was far greater (as we have subsequently learned), and the returns should have been proportionately greater – but they were not. Demand for these securities from financial entities searching for return no doubt caused these spreads to be less. This chase for yield during a low interest rate environment (thanks to Mr. Greenspan) is a big factor in the financial pain our country's financial institutions are now going through.

I don't recall an examiner ever bringing up the issue of systemic risk involving credit card receivables or student loan receivables. The ratings issued by Fitch, S & P, and Moody seemed to be all that mattered. The securities were floating rates with short durations. This made them look like good investments to your examiners, given their fixation on interest rate risk.

I would suggest that the NCUA assign a task force of its top people to come up with a system to address systemic risk.

Another issue which needs to be addressed involves the deposits which the corporate credit unions have with the NCUSIF. Our state's corporate has assets of about $1.5 billion, yet it only has about $160,000 on deposit with the fund. My credit union has $101 million in assets, yet our NCUSIF deposit is $855,000. Our reduction in income because of this deposit level is far greater proportionately than that of the corporate. Yet the risk to the fund is much greater for corporate credit unions because of the investment powers they have that my credit union doesn't have.

My suggestion would be to change the manner in which corporate credit unions place funds on deposit in the NCUSIF. One possibility would be to make their required deposit 1% of assets, instead of 1% of insured deposits.

Another possibility would be to restructure the regulatory or exam fee. Our corporate is state-chartered, and they pay the state regulators an exam fee. Yet the NCUA incurs considerable expense examining the corporate. The net result is the state regulator gets the revenue, but the NCUA absorbs the exam cost. The way I look at it, the individual credit unions are now absorbing this cost since the return to the NCUSIF on $160,000 does not nearly cover the expense of examining a complex corporate credit union. This should not be the case. The corporates should bear the cost of their exam and supervisory oversight.

One other issue which I would like to address involves the manner in which the required re-funding of the NCUSIF will be handled.

In January, our credit union adopted a budget which provided about $300,000 net income this year. We knew it would be a very difficult year and budgeted accordingly. We are now faced with having to come up with some $600-700,000 to send to the NCUSIF to help offset the losses at U.S. Central.

It seems to me that the losses at U.S. Central actually occurred during 2008. Yet my interpretation of the NCUA's letters regarding the NCUSIF re-funding leads me to believe that you are going to require us to run this through our 2009 income statement.

This is going to result in a very ugly year, income-wise, for us and a lot of other credit unions. We will have to explain this to our members at next year's annual meeting; and, right now, I am having a hard time coming up with a good explanation. These losses were no fault of our credit union's management – our use of the corporate system is minimal. Most of our investments are agency securities.

If the U.S. Central losses occurred last year, why could the NCUSIF re-funding not be handled as a charge against our Undivided Earnings. Our credit union is slightly over $100 million in assets, and our Undivided Earnings is slightly over $11 million. We could easily handle a $600-700,000 charge against U.E.

One final issue of a general nature involves mark-to-market accounting. I know that this concept did not originate with the NCUA and am not placing any blame on your agency. However, it is crazy to value investments as if the organization is going to be liquidated immediately. There are many financial institutions now being classified as insolvent because of unrealized investment losses. They may have solid cash flows and could survive the times we are going through. But the stigma attached to the so-called "insolvency" means that no one will invest in them. This whole concept of mark to market seems to me to be some form of self-flagellation that the financial industry (and other businesses, to a lesser extent) had forced upon it. The AICPA, SEC, and Congress should look at a makeover on mark to market.

While I am on mark to market, there is apparently a considerable amount of investment reclassification being done whereby investments are being moved from available for sale to hold to maturity. I would hazard a guess that this is being done to make the balance sheet look "prettier" at period-end. I have problems with this. Our credit union has a rule in place that applies to all investments. If the final maturity is less than five years, it is HTM. If the final is greater than five years, it is AFS. We have never reclassified any investment just to make the balance sheet look better. Those institutions doing this are making things look better short term, but they are putting themselves in a position where they cannot sell investments at future times when they may need to do so. They may face future liquidity problems because of this short term fix. This practice also distorts year-to-year comparisons because of different classifications at different times on the same investment.

I would now like to address the various questions you raised in your January 28 advance notice.

1. The Role of Corporates in the Credit Union System

My thoughts are that the entire corporate system needs to be restructured. I see no need for U.S. Central any longer. Also, there is no need for 28 separate corporate credit unions. These should be merged into regional corporates, similar to the FHLB or Federal Reserve structure.

Many of the existing corporates are small, and they probably lack the investment expertise to properly handle the investment function for the deposits placed with them. They therefore pass the funds along to U.S. Central. If U.S. Central were not in existence any longer, they would be forced to handle their own investment decisions. This would not be good. The regulatory oversight burden for the NCUA, and the danger to the entire credit union system would be greatly increased.

All of these regional corporates should be federally chartered. I see nothing to be gained by having state regulators involved in oversight of these corporates. (This would address the situation I mentioned above re the state regulators receiving exam revenues while the NCUA bears the cost of exams.)

1a. Payment System

You ask the question about payment systems being "isolated from other services to separate the risks." I do not perceive this as being an important issue. Separating these services would just increase the cost of payment systems, and we certainly don't need any higher costs right now. You seem to answer your own question with the last sentence of this section where you raise the issue "whether there is sufficient earnings potential in offering payment systems to support a limited business model that is restricted to payment system services only." No, there is not sufficient earnings potential.

1b. Liquidity and liquidity management.

Regarding liquidity and liquidity management, my comment would be that this has pretty much died out as an important issue with most credit unions. Our credit union has five times more in deposits than we have in loans. Our only liquidity need from the corporate would possibly be an overnight or very short term thing. I do accept that there are probably some credit unions that may encounter situations where they have liquidity needs, but they should address these situations in house. They should either generate more deposits with more attractive returns or make changes in their loan programs to bring their lending in line with their deposits. Leverage should have no place in the operation of a credit union.

In this section, you raise the issue of the need for cash flow duration limitations. I am not sure what you are addressing here; but, yes, I see a cash flow duration issue in corporate credit union investments. I am most familiar with our own state's corporate and cannot say that this is the case nation wide. One thing I have noted is a wide difference on some investments between duration and weighted average life. The investments, e.g., asset backs, etc., have very short durations because they have floating rates. On the other hand, the weighted average lives can be extremely long because of low payback rates. This is especially true with student loan receivables. On 12/31/08 our state's corporate had several SLMA asset backs with WAL's greater than 10 years. Unless this is an aberration because of recent slow payback speeds, the monthly cash flow on these has to be minimal.

I see corporate credit unions as falling into a trap because of the NCUA's past emphasis on interest rate risk, where the degree of risk is reflected in duration. This has led them to place less emphasis on periodic cash flows. Both are important, and your regulations should address this.

1c. Field of Membership issues.

On the issue of field of membership, I think there should be restrictions. If you have regional corporates, they should only serve the credit unions in that region. Competition between corporates leads to greater investment risk in order to pay higher returns. This may be good short term, but it can result in situations akin to what we are going through now.

1d. Expanded Investment Authority.

This section should have been combined with the section about risk based capital. These two go hand in hand. If a corporate wants expanded investment authority, they should have the capital in place to take on the risk. And the required capital should be proportionate to the amount of risk in the specific investment involved. Asset backed securities obviously have greater risk than government agency securities, and more capital should be in place when these type investments are made.

1e. Structure; two-tiered system.

I think I have already given my comments on this. To reiterate, no, there is no need for a two-tier system. Make the corporates regional.

2. Corporate Capital

On this issue, I do have some strong opinions. There should be standardized capitalization requirements for all credit unions which are members in the various corporates.

We have a very unfair situation in our state regarding required capital for membership in our corporate. The requirement is 1% of assets, to a maximum of $750,000. This 1% can be in two forms of capital, membership capital and paid-in capital. The flaw in this set-up is that it is very unfair to smaller credit unions. Our credit union with $100 million in assets has, proportionately, a much larger degree of risk than a credit union $1 billion in assets. This is outrageous. As I say, NCUA should set standards which require that all corporate credit union members take the same proportionate degree of risk in order to be a corporate member. Those that choose to take more risk by buying paid-in capital certainly should be allowed to do so – but this would be their choice. It should not be mandated by the corporate's policies.

2a. Core Capital.

Core capital does not seem to be a big issue to me. This is not a stand alone issue. It must be balanced against the amount of risk in the investment portfolio. I would add that if the NCUA insists on some certain level of Undivided Earnings as a required portion of core capital, this could result in considerable operational costs being passed on to the corporate's members. If costs for payment systems get out of line because of a corporate's need to increase Undivided Earnings, credit unions will start looking elsewhere for these services. I cannot say whether this is good or bad, but I can see it happening.

Other than the issues I have already mentioned, I have nothing further to add regarding membership capital. At our credit union, we look at the entire $750,000 we have in membership capital and paid-in capital as money at risk, although they do have separate structures.

2b. Risk-based capital and contributed capital requirements.

I have already addressed the risk based capital question. Regarding contributed capital requirements, my recommendation would be to have a national standard for membership capital in order for a credit union to use the corporate's services. Any additional capital should be at the individual credit union's discretion. However, the NCUA probably should set some asset percentage for a maximum corporate capital investment to control the degree of risk the credit unions may take on.

3. Permissible Investments.

On this issue, I have conflicting thoughts. If the corporates can only invest in the same securities that individual credit unions invest in, what added value do they bring to the system? On the other hand, the investments that the corporates have been allowed to make that were not allowable for the individual credit unions, e.g., asset backed securities, are the things that are looking so ugly on the corporate portfolios now. My thoughts go back to the issue of risk based capital. If the corporates can generate enough Undivided Earnings and sell enough paid-in capital to enable them to take on more risk, they probably should be allowed to have access to a wider range of investments. But the capital should come first, not the other way around.

4. Credit Risk Management.

Credit risk management is a "work in progress" for a lot of folks now. I think we all agree that the old system of relying on rating agencies to tell us what is good or bad was flawed. Adding a requirement that we get more than one obviously flawed rating in order to purchase a given security seems pointless.

Changes are coming in security ratings. I think the rating agencies are going to be forced to start taking systemic risk into account when they perform their risk analysis.

As I understand the rating agencies, the issuer of the securities pays them. This seems flawed. How are they going to be completely unbiased given this setup? Yes, their reputations are endangered when they give something a good rating and it goes bad. But it seems they have covered themselves contractually where they do not have monetary risk when they make flawed rating decisions.

Perhaps a better system would be for the buyer to pay the rating agency but receive some type of default insurance in addition to the rating. But we all know that the past forms of default insurance were also flawed and have caused billions in losses worldwide (think AIG). As I say, it is a "work in progress." I wouldn't hazard a guess as to how this particular issue will play out.

5. Asset Liability Management.

On this issue, I think your consideration of mandatory modeling and testing of credit spread increases is a logical step. This would address, to some extent, systemic risk. But I might add that no model would likely have forewarned us that we would be facing the situation we are all in now. This would have required some very subjective reasoning by some very smart people.

6. Corporate Governance.

Corporate governance needs overhauling. A much higher degree of professionalism needs to be in place in the corporate system.

Yes, there should be term limits. Yes, corporate directors should be paid. Yes, there should be greater transparency for executive compensation. Yes, there should be minimum qualifications and training requirements for corporate directors.

I think that the concept of "outside directors" is good. Most corporates likely have member credit unions which serve colleges and universities. There are finance, accounting, and economics professors at these colleges. These would be great places from which to recruit outside directors. These outside directors certainly should be compensated, just as all other directors should be. There should be more than one of these well-trained outside directors on each corporate Board of Directors.

Another issue concerning directors involves trade associations. At one time, I believe certain directors at U.S. Central held these seats because of a position they held with a trade association. This may or may not still be the case. If it is, this should be stopped. There is a potential for conflict of interest in such policies. This should be addressed.

I would also add that I feel that some positions on corporate boards should be NCUA appointments, with perhaps some input from state credit union regulators. Just the fact that some credit union official is popular and can get votes does not necessarily make him a good corporate director. The NCUA and state examiners very quickly recognize which credit unions have good management and which do not during their annual exams. The examiner force could be a good source of recommendations for NCUA appointments to corporate boards. The NCUA (and the state regulators) have reputational risk based on the actions of corporate boards and therefore should have some input into who serves on these boards.

Submitted by:

James W. Adams, Treasurer
Board of Directors
Railroad Federal Credit Union
1808 Second Ave., S.,
Irondale, Al., 35210